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J. Warren Huff

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TEXAS BUSINESS AND COMMERCE CODE SECTION 27.01: AN ALTERNATIVE TO FEDERAL SECURITIES FRAUD REMEDIES

by J. Warren Huff

Federal regulation of transactions in securities has expanded enormously since enactment of the federal securities acts.¹ A significant portion of this expansion has resulted from the courts' implication of private damage actions and their application of this remedy to an ever-expanding class of transactions. Recent United States Supreme Court decisions have evidenced concern over these developments and have operated to curtail the expansion of the scope of protection afforded by the federal securities laws.² Part I of this Comment illustrates this recent trend with respect to private damage actions through an analysis of several Supreme Court decisions under Securities and Exchange Commission rule 10b-5 and concludes that the decreasing availability of federal remedies should result in an increased reliance on the remedies provided by state law.

There are essentially three state law remedies for securities fraud available in Texas: the common law fraud action, section 33 of the Texas Securities Act,³ and section 27.01 of the Texas Business and Commerce Code.⁴ Of these potential avenues of relief, section 27.01 has been the least used. This statute was initially enacted in 1919,⁵ and was designed to codify, with some modification, the common law action of fraud, thus providing more effective relief for fraud practiced in transactions in stock and real estate. Advantages afforded to the plaintiff by section 27.01 include: (a) plaintiff is not required to prove that representations of fact were made with scienter; (b) plaintiff may bring an action on a false representation communicated in the form of a promise; (c) damages are measured on a loss-of-bargain rather than on an out-of-pocket formula; and (d) treble damages may be awarded when false representations are made willfully. Part II of this Comment examines the history and elements of section 27.01

1. 15 U.S.C. §§ 77a-77bbbb (1976) (The Securities Act of 1933); *id.* §§ 78a-78kk (The Securities Exchange Act of 1934).

2. *See Sante Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977); *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1 (1977); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Foremost-McKesson, Inc. v. Provident Sec. Co.*, 423 U.S. 232 (1976); *Rondeau v. Mosinee Paper Corp.*, 422 U.S. 49 (1975); *United Hous. Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412 (1975); *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582 (1973).

3. TEX. REV. CIV. STAT. ANN. art. 581—33(A)(2) (Vernon Supp. 1978-1979).

4. TEX. BUS. & COM. CODE ANN. § 27.01 (Vernon 1968). The text of this statute is set out at note 48 *infra*.

5. 1919 Tex. Gen. Laws ch. 43, §§ 1-3, at 77.

in order to illustrate the utility of proceeding under it in appropriate circumstances.

I. THE SUPREME COURT AND PRIVATE ACTIONS UNDER RULE 10b-5

A review of state and federal securities regulation illustrates that SEC rule 10b-5⁶ has become the most important antifraud provision.⁷ Although originally intended by the Securities and Exchange Commission as a makeshift remedy for fraud in the purchase of securities,⁸ the rule has expanded rapidly along two lines.⁹ First, it has been judicially construed to provide an implied cause of action for securities fraud to private plaintiffs.¹⁰ Secondly, it has been applied to a "startling variety of everyday transactions."¹¹ Recent decisions of the Supreme Court, however, have expressed concern over this trend and have limited the scope of the remedy available to private plaintiffs under rule 10b-5.

The best example of the Court's concern over the expansion of rule 10b-5 coverage is presented in *Blue Chip Stamps v. Manor Drug Stores*.¹² In *Blue Chip*, pursuant to an antitrust consent decree that permitted reorganization of Blue Chip (Old), a substantial number of shares of Blue Chip (New) was offered to retail users of the company's stamp service who had not been shareholders in Blue Chip (Old). The offer was attractively priced, and more than fifty percent of the shares offered were purchased. Approximately two years later, plaintiffs, who were offerees but not purchasers of the shares, brought an action under rule 10b-5 alleging that the prospectus was materially misleading because it was overly pessimistic and discouraged acceptance of the shares.¹³ The Supreme Court, relying on

6. 17 C.F.R. § 240.10b-5 (1978).

7. 1 A. BROMBERG, *SECURITIES LAW: FRAUD* § 1.1, at 5 (1967).

8. *See Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

9. Lowenfels, *Recent Supreme Court Decisions Under the Federal Securities Laws: The Pendulum Swings*, 65 GEO. L.J. 891, 892 (1977).

10. *Id.* *See also* *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 150-54 (1972); *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 (1971).

11. 1 A. BROMBERG, *supra* note 7, § 1.1, at 4; Lowenfels, *supra* note 9, at 922. *See, e.g.*, *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974) (unintentional misrepresentations concerning promissory notes); *Easton v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973) (shareholders of corporation purchasing a leasing business may sue even though not purchasers of stock), *cert. denied*, 416 U.S. 960 (1974); *Rogen v. Ilikon Corp.*, 361 F.2d 260 (1st Cir. 1966) (former president of corporation allowed to sue for company's failure to inform him of improvements in process disclosed at meeting that he failed to attend); *Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962) (investor-president of development concern allowed to recover investment on inaccurate income projection that he was given), *subseq. opinion*, 333 F.2d 568 (9th Cir. 1964).

12. 421 U.S. 723 (1975). *See generally* Lowenfels, *supra* note 9, at 893-97; *The Supreme Court, 1974 Term*, 89 HARV. L. REV. 47, 262 (1975); Note, *Birnbaum: Revisited and Triumphant—Blue Chip Stamps v. Manor Drug Stores*, 25 DE PAUL L. REV. 132 (1975); Note, *Standing Under Rule 10b-5 After Blue Chip Stamps*, 75 MICH. L. REV. 413 (1976); Comment, *Blue Chip Stamps v. Manor Drug Stores: Failure to Solve the Purchaser-Seller Problem*, 70 NW. L. REV. 965 (1976); Note, *Affirmation of the Purchaser-Seller Limitation: Blue Chip Stamps v. Manor Drug Stores*, 29 SW. L.J. 951 (1975).

13. 421 U.S. at 726-27.

Birnbaum v. Newport Steel Corp.,¹⁴ held that private damage actions under rule 10b-5 were limited to actual purchasers or sellers of securities.¹⁵

Blue Chip marks the Court's major policy shift from an expansive interpretation of rule 10b-5 to the current trend of limiting the scope of that rule. In explaining the basis for this shift, the Court stated: "There has been widespread recognition that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."¹⁶ The potential for vexatious litigation was attributed to two factors. First, even when a complaint has little chance of success, it may have settlement value because of its disruptive effect on normal business activity and the potential for abuse of liberal discovery provisions.¹⁷ Secondly, the generalized contours of liability under rule 10b-5 would present the trier of fact with "many rather hazy issues of historical fact" that depend almost entirely on oral evidence for proof, and therefore would be impossible to refute prior to trial.¹⁸ For these reasons, the Court concluded that policy considerations required application of the *Birnbaum* purchaser-seller limitation to suits brought under rule 10b-5.

The Supreme Court took a second opportunity to restrict the scope of rule 10b-5 in *Ernst & Ernst v. Hochfelder*.¹⁹ The petitioner, Ernst & Ernst, an accounting firm conducting an annual audit of First Securities Company of Chicago (a securities broker-dealer), failed to discover a scheme to defraud investors implemented by the president and principal stockholder of First Securities.²⁰ A group of defrauded investors brought suit under rule 10b-5, alleging that Ernst & Ernst had conducted its audit in a negligent fashion. The district court granted Ernst & Ernst's motion for summary judgment, concluding that there was no genuine issue of material fact with respect to whether Ernst & Ernst had conducted its audit in accordance with generally accepted auditing standards.²¹ The Court of Ap-

14. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952). *Birnbaum* established the requirement that the plaintiff in a private action for damages under § 10(b) and rule 10b-5 must be a purchaser or seller of securities. 193 F.2d at 465.

15. 421 U.S. at 749.

16. *Id.* at 739.

17. *Id.* at 740-41.

18. *Id.* at 743-44.

19. 425 U.S. 185 (1976). *See generally* Note, *The Scierter Requirement in SEC Injunctive Enforcement of Section 10(b) After Ernst & Ernst v. Hochfelder*, 77 COLUM. L. REV. 419 (1977); Note, *SEC Enforcement Actions to Enjoin Violations of Section 10(b) and Rule 10b-5: The Scierter Question*, 5 HOFSTRA L. REV. 831 (1977); Note, *Scierter Required for Civil Liability Under SEC Rule 10b-5*, 28 MERCER L. REV. 401 (1976); Note, *Rule 10b-5: Scierter Displaces the Flexible Duty Standard*, 56 NEB. L. REV. 382 (1977); Note, *Scierter's Scope and Application in Rule 10b-5 Actions: An Analysis in Light of Hochfelder*, 52 NOTRE DAME LAW. 925 (1977).

20. More specifically, respondent's action was grounded on the theory that Ernst & Ernst's failure to discover the president's "mail rule" was negligent. The "mail rule" was the president's practice of always opening his own mail even if it arrived while he was absent. Respondent contended that if Ernst & Ernst had discovered the practice, they would have been forced to report it to the SEC as an irregular procedure that prevented effective audit. 425 U.S. at 190.

21. *Hochfelder v. Midwest Stock Exch.*, 350 F. Supp. 1122 (N.D. Ill. 1972). Plaintiff

peals for the Seventh Circuit reversed and remanded, holding that genuine issues of material fact did exist.²² The Supreme Court granted certiorari and determined that a private cause of action would not lie under section 10(b) and rule 10b-5 without an allegation of either scienter or an intent to deceive, manipulate, or defraud.²³ Emphasizing the language of section 10(b), the Court stated that "[t]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct."²⁴ The Court, therefore, concluded that section 10(b) was not intended to provide a remedy for mere negligent conduct.²⁵

Although the Court felt that its scienter analysis sufficiently disposed of the complaint, the Court nevertheless supplemented its rationale with two additional arguments. First, the legislative history of section 10(b) indicated a congressional intent to create private actions for damages only for "illicit practices."²⁶ Secondly, in each instance that express civil liability was created in the securities acts, Congress specified the standard to be applied.²⁷ The Court found significant Congress's failure to stipulate a negligence standard in section 10(b).²⁸ The Court concluded by holding that since section 10(b) did not prohibit unintentional conduct, rule 10b-5 could not prohibit unintentional conduct because the SEC has no rulemaking authority beyond that delegated to it under the statute.²⁹

By basing its decision on the legislative history and language of section 10(b), the Court found it unnecessary to discuss considerations of policy. Nevertheless, it took notice of the policy considerations of the *Blue Chip* decision, and expressed concern that a negligence standard would significantly broaden the class of plaintiffs who could seek to impose liability on accountants and other experts.³⁰ The Court feared that this resulting extension of liability would raise serious policy questions not yet addressed by Congress.³¹

The most recent mandate from the Court on the scope of rule 10b-5

Olga Hochfelder filed an action on Feb. 19, 1971, in district court against the Midwest Stock Exchange and Ernst & Ernst. On May 18, 1971, a separate but identical complaint was filed by plaintiff Leon S. Martin. Midwest and Ernst & Ernst filed motions for summary judgment applicable to both cases. The district court granted summary judgment in favor of the Midwest Stock Exchange, and the Seventh Circuit affirmed in the consolidated appeal. *Hochfelder v. Midwest Stock Exch.*, 503 F.2d 364 (8th Cir. 1974). Subsequent to the grant of summary judgment to Midwest, the district court granted summary judgment in favor of Ernst & Ernst. The appeals were consolidated by stipulation of the parties and the circuit court's order of Nov. 13, 1973.

22. *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100 (7th Cir. 1974).

23. 425 U.S. at 193.

24. *Id.* at 197.

25. *Id.*

26. *Id.* at 206; see H.R. REP. NO. 1383, 73d Cong., 2d Sess. 10-11, 20-21 (1934).

27. 425 U.S. at 207.

28. *Id.* at 208.

29. *Id.* at 214.

30. *Id.* at 214 n.33.

31. Lowenfels, *supra* note 9, at 900.

came in *Sante Fe Industries, Inc. v. Green*.³² In that case Sante Fe Industries used the Delaware short form merger statute³³ to eliminate the publicly held shares of its ninety-five percent owned subsidiary, Kirby Lumber Corporation, and return it to private ownership status. Under the statute, minority shareholders were required either to exchange their shares for cash in an amount determined by the parent corporation or to pursue their appraisal rights in state court.³⁴ Plaintiffs, minority shareholders of Kirby, were dissatisfied with the amount offered by Sante Fe and brought an action in federal court alleging violations of section 10(b) and rule 10b-5 relating to the undervaluation of the shares. The district court granted Sante Fe's motion to dismiss on the grounds that the complaint failed to allege an omission, misstatement, or fraudulent conduct that would have affected the shareholders' judgment.³⁵ The Court of Appeals for the Second Circuit reversed, holding that a complaint alleges a claim under rule 10b-5 when it charges, in connection with a short form merger, that the majority has breached its fiduciary duty to minority shareholders by effecting the merger without any justifiable business purpose.³⁶

The Supreme Court, on review, refused to impose a federal standard of fair dealing with shareholders, holding that the plaintiffs' claim of fraud and breach of fiduciary duty did not state a cause of action under section 10(b) or rule 10b-5.³⁷ The Court relied on two lines of reasoning. Following its decision in *Ernst & Ernst*, the Court reiterated that section 10(b) and rule 10b-5 only reach acts that are "manipulative or deceptive."³⁸ Manipulative conduct was defined as that which is intended to mislead investors by artificially affecting market prices and does not include the instances of corporate mismanagement contemplated by plaintiffs' suit.³⁹ Deceptive conduct was said to arise from an omission, misstatement, or nondisclosure.⁴⁰ Since the district court found that none of the plaintiffs were deceived, section 10(b) and rule 10b-5 were inapplicable to the short form merger transaction.⁴¹ The Court also examined other factors that weighed

32. 430 U.S. 462 (1977). See generally *Symposium: Corporation Notes, Going Private: Santa Fe Industries, Inc. v. Green—The Supreme Court Decision in Rule 10b-5 Actions*, 30 OKLA. L. REV. 593 (1977); Note, *The "New Fraud" Becomes No Fraud: Santa Fe Industries, Inc. v. Green*, 31 SW. L.J. 739 (1977).

33. DEL. CODE ANN. tit. 8, § 253 (1975 & Supp. 1978).

34. *Id.*

35. *Green v. Santa Fe Indus., Inc.*, 391 F. Supp. 849 (S.D.N.Y. 1975).

36. *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1291 (2d Cir. 1976).

37. 430 U.S. at 476.

38. 430 U.S. at 472. The court reasoned:

To the extent that the Court of Appeals would rely on the use of the term "fraud" in Rule 10b-5 to bring within the ambit of the Rule all breaches of fiduciary duty in connection with a securities transaction, its interpretation would, like the interpretation rejected by the Court in *Ernst & Ernst*, "add a gloss to the operative language of the statute quite different from its commonly accepted meaning."

Id.

39. *Id.* at 477.

40. *Id.* at 474.

41. *Id.*

against permitting the plaintiffs' action to be brought under rule 10b-5.⁴² First, the Court observed that allowing this action would not promote the fundamental purpose of the Securities Exchange Act of 1934, namely, implementation of a philosophy of full and fair disclosure.⁴³ Secondly, and more important to the present discussion, the Court believed that this was a cause of action "traditionally relegated to state law."⁴⁴ The Court was concerned that the effect of extending 10b-5 protection to this type of transaction "would be to bring within the Rule a wide variety of corporate conduct traditionally left to state regulation."⁴⁵ The Court was reluctant to "federalize" the substantial portion of corporation laws that deals with transactions in securities.⁴⁶

These cases are instructive in two respects. First, they illustrate the bias of the Court against expansion of the scope of rule 10b-5 and federal remedies in general. *Blue Chip* and *Sante Fe* both rely on policy arguments emphasizing the Court's concern with the evils of vexatious litigation and the resulting expense to the investing public. *Sante Fe* further illustrates the Court's unwillingness to allow federal intervention into areas that traditionally have been within the realm of state law. Secondly, these cases are examples of the types of severe substantive limitations recently imposed by the Court on private plaintiffs who attempt to bring actions under rule 10b-5. For instance, the purchaser-seller requirement of *Blue Chip* reduces the number of potential plaintiffs with standing under the rule. The scienter requirement of *Hochfelder* excludes actions grounded on negligent conduct and increases the difficulty of proving claims. The *Sante Fe* decision operates to limit rule 10b-5 to conduct involving deception or manipulation and excludes actions based solely on a breach of fiduciary duty. With the retreat of the federal courts from expansion of application of the federal securities laws, as evidenced by these cases, state remedies will be increasingly used to provide redress for defrauded investors.

II. TEXAS BUSINESS AND COMMERCE CODE SECTION 27.01

A. History

The statutory predecessor of section 27.01 of the Texas Business and Commerce Code⁴⁷ was enacted to proscribe fraud in the sale of real estate

42. *Id.* at 477.

43. *Id.* at 477-78.

44. *Id.* at 478 (quoting *Cort v. Ash*, 422 U.S. 66, 78 (1974)).

45. *Id.*

46. *Id.* at 479.

47. Section 27.01 provides:

- (a) Fraud in a transaction involving real estate or stock in a corporation or joint stock company consists of a
 - (1) false representation of a past or existing material fact, when the false representation is
 - (A) made to a person for the purpose of inducing that person to enter into a contract; and
 - (B) relied on by that person in entering into that contract; or
 - (2) false promise to do an act, when the false promise is

and stock as a response to fraudulent oil stock promotions and land sale schemes that had occurred in the lower Rio Grande valley.⁴⁸ The original statute, article 4004 of the Texas Revised Civil Statutes,⁴⁹ was enacted in

- (A) material;
- (B) made with the intention of not fulfilling it;
- (C) made to a person for the purpose of inducing that person to enter into a contract; and
- (D) relied on by that person in entering into that contract.

(b) A person who makes a false representation or false promise, and a person who benefits from that false representation or false promise, commit the fraud described in Subsection (a) of this section and are jointly and severally liable to the person defrauded for actual damages. The measure of actual damages is the difference between the value of the real estate or stock as represented or promised, and its actual value in the condition in which it is delivered at the time of the contract.

(c) A person who wilfully makes a false representation or false promise, and a person who knowingly benefits from a false representation or false promise, commit the fraud described in Subsection (a) of this section and are liable to the person defrauded for exemplary damages not to exceed twice the amount of the actual damages.

TEX. BUS. & COM. CODE ANN. art. 27.01 (Vernon 1968). The statute was originally enacted at 1919 Tex. Gen. Laws ch. 43, §§ 103, at 77 (Tex. Civ. Stat. art. 3973 (Vernon Supp. 1922), later renumbered as Tex. Rev. Civ. Stat. Ann. art. 4004, repealed, 1967 Tex. Gen. Laws ch. 785, § 4, at 2619).

48. The emergency clause of the statute stated:

The fact that there are now in this State a number of fraudulent land schemes, and that a great number of citizens of this State have been defrauded thereby, and that there is now no comprehensive law protecting citizens of this State from being defrauded by false representations and promises, creates an emergency and an imperative public necessity requiring that the Constitutional rule requiring bills to be read on three several days be suspended and that this Act take effect and be in force from and after its passage, and it is so enacted.

1919 Tex. Gen. Laws ch. 43, § 4, at 77. The legislation as introduced dealt only with fraudulent land sale schemes, but was later broadened to include oil stock promotions. *Thompson v. American Power & Light Co.*, 192 F.2d 651, 653 (5th Cir. 1951).

49. The statute provided:

Section 1. Actionable fraud in this State with regard to transactions in real estate or in stock in corporations or joint stock companies shall consist of either a false representation of a past or existing material fact, or false promise to do some act in the future which is made as a material inducement to another party to enter into a contract and but for which promise said party would not have entered into said contract, provided however that whenever a promise thus made has not been complied with by the party making it within reasonable time, it shall be presumed that it was falsely and fraudulently made, and the burden shall be on the party making it to show that it was made in good faith but was prevented from complying therewith by the act of God, the public enemy or by some equitable reason.

Sec. 2. All persons guilty of fraud, as defined in this Act, shall be liable to the person defrauded for all actual damages suffered the rule of damages being the difference between the value of the property as represented or as [it] would have been worth, had the promise been fulfilled, and the actual value of the property in the condition it is delivered at the time of the contract.

Sec. 3. All persons making the false representations or promises and all persons deriving the benefit of said fraud, shall be jointly and severally liable in actual damages, and in addition thereto, all persons knowingly and wilfully making such false representations or promises or knowingly taking the advantage of said fraud shall be liable in exemplary damages to the person defrauded in such amount as shall be assessed by the Jury, not to exceed double the amount of the actual damages suffered.

1919 Tex. Gen. Laws ch. 43, §§ 1-3, at 77 (Tex. Rev. Civ. Stat. Ann. art. 4004 (Vernon 1966),

1919. It defined fraud in terms of false representations and false promises,⁵⁰ and altered the common law fraud action in two respects. First, the statute modified the common law rule concerning the burden of proof when the fraudulent representation consisted of a promise rather than a fact. Under common law the plaintiff was required to prove that the promisor made the promise with a present intent never to perform it.⁵¹ The legislature shifted the burden of proof by creating a presumption that a promise to do an act was made falsely and fraudulently when the promise was given as a material inducement to a contract but not fulfilled within a reasonable time.⁵² To rebut the presumption and avoid liability the promisor was required to show that he had been prevented from performing "by the act of God, the public enemy or by some equitable reason."⁵³ In *Clem v. Evans*⁵⁴ this portion of the statute was declared unconstitutional as violative of the due process clause of the Texas Constitution.⁵⁵ The court reasoned that the promisor's insincerity makes the conduct fraudulent and that fundamental law guarantees the promisor the right to rebut this charge of insincerity.⁵⁶ The court therefore concluded that the legislature had no power to limit the promisor's rebuttal to three specific defenses as this limitation operated to deprive the defendant of his property without due process of law.⁵⁷

Secondly, the statute modified the common law measure of damages. Texas courts apply an out-of-pocket measure of recovery in common law fraud actions.⁵⁸ Under this theory the defrauded party is entitled to recover the difference between the value of what he relinquished and the value of what he received. The predecessor of section 27.01, however, provided a loss-of-bargain measure of damages that allowed the defrauded

repealed, 1967 Tex. Gen. Laws ch. 785, § 4, at 2619). Article 4004 differs in one respect from the language of the statute in 1919 Tex. Gen. Laws ch. 43, § 3, at 77. The version in Tex. Gen. Laws provides that "all persons knowingly and wilfully" making false representations are liable for exemplary damages. The term "knowingly" is omitted from art. 4004, which provides that "all persons wilfully" making false representations are liable for exemplary damages. For purposes of this discussion, however, the two versions of the statutes are treated as identical.

50. Miller, *Innocent Misrepresentation as the Basis of an Action for Deceit*, 6 TEXAS L. REV. 151, 155 (1928).

51. See *Chicago T. & M.C. Ry. v. Titterington*, 84 Tex. 218, 19 S.W. 472 (1892); *Roark v. Prideaux*, 284 S.W. 624 (Tex. Civ. App.—Fort Worth 1926), *aff'd*, 291 S.W. 868 (Tex. Comm'n App. 1927, judgment adopted).

52. 1919 Tex. Gen. Laws ch. 43, § 1, at 77 (Tex. Rev. Civ. Stat. Ann. art. 4004 (Vernon 1966)) (repealed 1967).

53. *Id.*

54. 291 S.W. 871, 879 (Tex. Comm'n App. 1927, holding approved).

55. TEX. CONST. art. I, § 19, dealing with deprivation of life, liberty, or property without "due course of the law of the land."

56. 291 S.W. at 872.

57. *Id.* In a companion case, *Prideaux v. Roark*, 291 S.W. 868, 871 (Tex. Comm'n App. 1927, judgment adopted), the court similarly found that portion of the statute unconstitutional. The *Clem* court believed that this provision also violated the due process clause of the Federal Constitution, U.S. CONST. amend. XIV, § 2, even though the United States Supreme Court held otherwise in *James-Dickinson Farm Mortgage Co. v. Harry*, 273 U.S. 119 (1927).

58. See *George v. Hesse*, 100 Tex. 44, 46-48, 93 S.W. 107, 108 (1906). See also Miller, *supra* note 50, at 156.

party to recover the difference between the actual value of the real estate or stock and the value of the real estate or stock if it had been as represented or promised.⁵⁹ The adoption of the statutory loss-of-bargain measure effectively gave the defrauded party damages for breach of contract in a fraud action, usually resulting in a more generous recovery than one based on the out-of-pocket measure.⁶⁰

The Texas Legislature made several changes in the statute when article 4004 was codified into the Business and Commerce Code as section 27.01. For instance, the portion of the statute relating to burden of proof in actions based on a false promise, which had been declared unconstitutional, was deleted.⁶¹ In addition, the language used in formulating both the inducement and reliance requirements was changed slightly.⁶² Finally, section 27.01 bifurcated the fraud action into portions prescribing the elements for an action based on misrepresentation of a fact and for an action based on a false promise.

In an action for misrepresentation of a fact the defrauded party is required to prove: (1) that a misrepresentation was made; (2) that it was material; (3) that it was made to induce the party to enter into a contract; (4) that it was relied on by the defrauded party in entering into a contract; and (5) that the defrauded party suffered an injury.⁶³ If the action is based on a false promise, then in addition to these elements the statute requires the defrauded party to prove that the representor made the promise with the intent of not fulfilling it.⁶⁴

59. 1919 Tex. Gen. Laws ch. 43, § 2, at 77 (Tex. Rev. Civ. Stat. Ann. art. 4004 (Vernon 1966)) (repealed 1967).

60. See W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 10, at 133-34 (4th ed. 1971).

61. Compare 1919 Tex. Gen. Laws ch. 43, § 1, at 77 (Tex. Rev. Civ. Stat. Ann. art. 4004 (Vernon 1966)) (repealed 1967) with TEX. BUS. & COM. CODE ANN. § 27.01(a)(2) (Vernon 1968).

62. With respect to the inducement requirement, art. 4004 required that the representation be made "as a material inducement to another party to enter into a contract." 1919 Tex. Gen. Laws ch. 43, § 1, at 77 (Tex. Rev. Civ. Stat. Ann. art. 4004 (Vernon 1966)) (repealed 1967). Section 27.01, however, requires that the representation be "made to a person for the purpose of inducing that person to enter into a contract." TEX. BUS. & COM. CODE ANN. § 27.01(a)(1)(A), (2)(C) (Vernon 1968). A similar change was made in the language of the statute concerning the reliance requirement. Article 4004 required the plaintiff to demonstrate that "but for which promise" he "would not have entered into said contract." 1919 Tex. Gen. Laws ch. 43, § 1, at 77 (Tex. Rev. Civ. Stat. Ann. art. 4004 (Vernon 1966)) (repealed 1967). Section 27.01 requires that the representation be "relied on by that person in entering into that contract." TEX. BUS. & COM. CODE ANN. § 27.01(a)(1)(B), (2)(D) (Vernon 1968).

Although the differences in the language of the two statutes do not appear to change the substantive requirements of the cause of action under the statute, sufficient differences exist to warrant identification of the cases decided under art. 4004 and § 27.01. Thus, a parenthetical following the citation of each case decided under the statute will identify the version of the statute under which the case was decided.

Note also that citation to cases brought for fraud in the sale of real estate under the statute is made throughout this Comment. Since "actionable fraud" is defined in the statute for both stock and real estate transactions, the real estate cases are equally applicable to actions for fraud in transactions involving stock. Nevertheless, when a real estate case is cited the parenthetical will indicate it as such.

63. TEX. BUS. & COM. CODE ANN. § 27.01(a)(1) (Vernon 1968).

64. *Id.* § 27.01(a)(2).

B. *Misrepresentation*

Section 27.01 defines "actionable fraud" as either a false representation of a past or existing material fact⁶⁵ or a false promise to do an act made with the intention of not fulfilling it.⁶⁶ Although the clearest case of misrepresentation is the communication of a deliberate or intentional falsehood, the case law illustrates that the statute embraces much more than this simple situation. For instance, the common law approach of examining whether the effect of a particular representation on an ordinary mind may be deceptive or misleading has been applied in actions brought under the statute. In *Chandler v. Butler*⁶⁷ the purchaser of stock made representations that he was paying \$45.00 per share in response to the seller's inquiry concerning the market value of the stock. The seller testified that he had no knowledge of the market value and that the purchaser's representation led him to believe that \$45.00 per share was the market value of the stock. The court held that the evasive statement of the purchaser, whether true or not, constituted an actionable misrepresentation.⁶⁸ It reasoned that a representation literally true was actionable if used to create an impression substantially false. In this case, the purchaser had superior knowledge of the value of the stock and knew that the seller was relying on his expertise. Thus, the purchaser was under a duty to make truthful representations to the seller and had no right to evade, conceal or suppress the truth. Similarly, if the defendant is under a duty to speak, concealment of the truth is the equivalent of an affirmative misrepresentation.⁶⁹ A duty to speak arises if the possessor of information knows that the other party is ignorant of the facts and does not have an equal opportunity of discovering the truth.⁷⁰

Probably the most frequently litigated issue under the statute concerning the character of the misrepresentation is whether it constitutes a fact or a mere expression of opinion. Generally, expressions of opinion cannot be the basis of an action for fraud under section 27.01.⁷¹ For example, in

65. *Id.* § 27.01(a)(1).

66. *Id.* § 27.01(a)(2).

67. 284 S.W.2d 388 (Tex. Civ. App.—Texarkana 1955, no writ) (art. 4004; fraud in a transaction involving stock).

68. *Id.* at 398.

69. *See Richman Trusts v. Kutner*, 504 S.W.2d 539, 544 (Tex. Civ. App.—Dallas 1973, writ ref'd n.r.e.) (§ 27.01; fraud in a transaction involving real estate); *Wink Enterprises, Inc. v. Dow*, 491 S.W.2d 451, 454 (Tex. Civ. App.—El Paso 1973, writ ref'd n.r.e.) (§ 27.01; fraud in a transaction involving stock). These two cases adopt the approach taken in common law fraud cases. *See Roland v. McCullough*, 561 S.W.2d 207 (Tex. Civ. App.—San Antonio 1977, writ ref'd n.r.e.); *American Marine Upholstery Co. v. Minsky*, 433 S.W.2d 717 (Tex. Civ. App.—Eastland 1968, writ ref'd n.r.e.); *Moore & Moore Drilling Co. v. White*, 345 S.W.2d 550 (Tex. Civ. App.—Dallas 1961, writ ref'd n.r.e.).

70. *Richman Trusts v. Kutner*, 504 S.W.2d 539, 544 (Tex. Civ. App.—Dallas 1973, writ ref'd n.r.e.) (§ 27.01; fraud in a transaction involving real estate); *Moore & Moore Drilling Co. v. White*, 345 S.W.2d 550, 555 (Tex. Civ. App.—Dallas 1961, writ ref'd n.r.e.) (common law fraud action).

71. The rule at common law is that "false representations are not actionable unless they relate to a fact susceptible of knowledge which existed at the time the representations were made, or had existed before that time." *Industrial Transp. Co. v. Russell*, 238 S.W. 1030,

*Stone v. Enstam*⁷² the plaintiff, a purchaser of stock in Worldcom, Incorporated, brought an action under section 27.01 alleging that the president of Worldcom made fraudulent representations that Worldcom would be in the black in its first year, and that the stock would sell in the future for forty to fifty dollars per share. The court of civil appeals, finding no evidence of misrepresentation of a material fact, stated that "[t]he speculative statements asserting that stock would eventually sell at a high price and that Worldcom would show a profit in the future are not statements of material fact presently existing which would constitute fraud under this section but rather are only statements of optimism and conjecture."⁷³ Similarly, in *Ryan v. Collins*⁷⁴ statements that stock was "hot," had "unlimited possibilities," and was a "solid buy" were found to be mere opinion by the court of civil appeals. The *Ryan* court observed that it was "well settled that in order to constitute actionable fraud the representation complained of must concern a material fact as distinguished from a mere matter of opinion, judgment, probability or expectation."⁷⁵

When there is an ostensible factual basis for the representation or when the special knowledge of the representor elevates what would normally be his opinion to a factual representation, courts will apply a stricter standard to the determination of whether a particular representation constitutes fact or opinion. In *Wink Enterprises, Inc. v. Dow*⁷⁶ the purchaser of stock in a bank brought suit on the seller's representation that "the bank was doing very well"⁷⁷ and that "[i]t was a good, sound bank and would continue to make money."⁷⁸ Reversing the trial court's grant of seller's motion for a directed verdict, the appellate court concluded that the representation in question was more than an opinion. It reasoned that the statement implied to the purchaser that facts existed that led the representor to believe that the bank was in good financial condition.⁷⁹ Hence, factual issues bearing on the question of fraud were present.⁸⁰ Similarly, other courts have found what would normally be considered an opinion to be an actionable representation when the representor intended it to be accepted as fact or when he could have reasonably expected the other party to rely on his

1031 (Tex. Civ. App.—Texarkana 1922), *aff'd*, 251 S.W. 1034 (Tex. Comm'n App. 1923, holding approved), *aff'd*, 113 Tex. 441, 248 S.W. 462 (1924). See also *Precision Motors, Inc. v. English*, 517 S.W.2d 371 (Tex. Civ. App.—Beaumont 1974, no writ); *Brooks v. Parr*, 507 S.W.2d 818 (Tex. Civ. App.—Amarillo 1974, no writ); *Hazle v. McDonald*, 449 S.W.2d 343 (Tex. Civ. App.—Dallas 1969, no writ).

72. 541 S.W.2d 743 (Tex. Civ. App.—Dallas 1976, no writ) (§ 27.01; fraud in a transaction involving stock).

73. *Id.* at 481.

74. 496 S.W.2d 205 (Tex. Civ. App.—Tyler 1973, writ ref'd n.r.e.) (§ 27.01; fraud in a transaction involving stock).

75. *Id.* at 210 (quoting *Fossier v. Morgan*, 474 S.W.2d 801 (Tex. Civ. App.—Houston [1st Dist.] 1971, no writ)).

76. 491 S.W.2d 451 (Tex. Civ. App.—El Paso 1973, writ ref'd n.r.e.) (§ 27.01; fraud in a transaction involving stock).

77. *Id.* at 453.

78. *Id.*

79. *Id.*

80. *Id.*

superior knowledge or skill.⁸¹

Not all courts follow this approach, however. At least one court has refused to impose liability absent a clear factual representation even though the representor had expertise or special knowledge of the subject of the representation. In *Maness v. Reese*⁸² the sale of a corporation was implemented by a redemption of the seller's stock valued at \$200,000. Subsequently, the business failed, and the purchaser brought suit, alleging that the seller and accountants for the corporation made fraudulent representations that the withdrawal of the \$200,000 from capital to effect the stock redemption plan would not impair the operations of the business. The court of civil appeals, reversing the lower court, held that the representations were not actionable, stating that they "certainly entailed business acumen, judgment and opinion based on many factors, some incapable of knowledge at the time this transfer was effected."⁸³ The court, however, observed that some evidence existed that defendants represented that after the redemption there would be a certain amount of capital available. The court noted that such evidence would have been proper inquiry for the jury.⁸⁴

At common law it is generally held that the state of mind of a person making a representation is an existing fact susceptible of actionable misrepresentation so that redress may be had for an expression of opinion contrary to that entertained by the representor.⁸⁵ This reasoning is equally applicable to actions brought under section 27.01. Thus, "expressions of opinion by a person, made with a knowledge of their falsity and with the fraudulent intent to induce the other party to act, are actionable" under the statute.⁸⁶

81. See *Bell v. Bradshaw*, 342 S.W.2d 185, 189-90 (Tex. Civ. App.—Dallas 1960, no writ) (art. 4004; fraud in a transaction involving real estate); *J.S. Curtiss & Co. v. White*, 90 S.W.2d 1095, 1097-98 (Tex. Civ. App.—El Paso 1935, writ *dism'd* by agr.) (art. 4004; fraud in a transaction involving stock); *Roark v. Prideaux*, 284 S.W. 624, 626 (Tex. Civ. App.—Fort Worth 1926) (art. 4004; fraud in a transaction involving stock), *aff'd*, 291 S.W. 868 (Tex. Comm'n App. 1927, judgment adopted). See also *Ryan v. Collins*, 496 S.W.2d 205, 210 (Tex. Civ. App.—Tyler 1973, writ *ref'd* n.r.e.) (§ 27.01; fraud in a transaction involving stock), in which the court stated that "[w]here no confidential relationship exists between the parties, a mere expression of an opinion . . . is not considered to be a misrepresentation of a material fact," thus implying that an opinion may be actionable if a confidential relationship exists between the parties.

82. 489 S.W.2d 660 (Tex. Civ. App.—Beaumont 1972, writ *ref'd* n.r.e.) (§ 27.01; fraud in a transaction involving stock).

83. *Id.* at 664.

84. *Id.*

85. "The state of a man's mind is as much a fact as the state of his digestion." *Edgington v. Fitzmaurice*, [1885] 29 Ch. D. 459, 483. See also *Merchandise Mart, Inc. v. Marcus*, 483 S.W.2d 893, 897 (Tex. Civ. App.—Tyler 1972), *motion to amend mandate* *dism'd*, 501 S.W.2d 712 (Tex. Civ. App.—Tyler 1973), *writ* *dism'd* *w.o.j.*, *per curiam*, 515 S.W.2d 663 (Tex. 1974), *mandate returned*, 518 S.W.2d 555 (Tex. Civ. App.—Tyler 1975); *Mangum Road Center v. Disclafani*, 450 S.W.2d 130, 135 (Tex. Civ. App.—Houston [14th Dist.] 1969, writ *ref'd* n.r.e.); *Harris v. Sanderson*, 178 S.W.2d 315, 318 (Tex. Civ. App.—Eastland 1944, writ *ref'd* w.o.m.); *Texas Farm Bureau Cotton Ass'n v. Craddock*, 285 S.W. 949, 950 (Tex. Civ. App.—Texarkana 1926, writ *ref'd*).

86. *J.S. Curtiss & Co. v. White*, 90 S.W.2d 1095, 1098 (Tex. Civ. App.—El Paso 1935, writ *dism'd* by agr.) (art. 4004; fraud in a transaction involving stock).

C. Materiality

Section 27.01 requires that the misrepresentation be material.⁸⁷ It appears that any representation that might affect the value of the stock or that a reasonable man would consider important in determining a course of action is material.⁸⁸ Thus, representations by a buyer or seller of stock concerning its value have been held to be material.⁸⁹ Further, representations regarding the future income that a stock will earn are material.⁹⁰

D. Inducement

Article 4004 of the Texas Revised Civil Statutes required that the representation be "made as a material inducement to another party to enter into a contract."⁹¹ This provision was misconstrued as requiring that the representation actually cause or induce the defrauded party to enter into a contract.⁹² The inducement requirement, however, concerned the intent of the party making the representation, and not the ultimate effect on the defrauded party. The Texas Supreme Court clarified this distinction in *Westcliff Co. v. Wall*.⁹³ The court held that "[a] person making a representation is only accountable for its truth or honesty to the very person or persons whom he seeks to influence."⁹⁴

The language of section 27.01 is clearer as it requires that the representation be "made to a person for the purpose of inducing that person to enter into a contract."⁹⁵ This important limitation on the potential liability of the maker of a false representation effectively restricts the statute to representations made in connection with an actual sales transaction or selling campaign. Thus, misleading press releases or false financial statements

87. TEX. BUS. & COM. CODE ANN. § 27.01(a)(1), (2)(A) (Vernon 1968).

88. Bordwine, *Civil Remedies Under the Texas Securities Laws*, 8 HOUS. L. REV. 657, 664 (1971). See also *Wheat v. Hall*, 535 F.2d 874, 876 (5th Cir. 1971), which applied the test of "whether a reasonable man would attach importance to the fact misrepresented in determining his course of action" to an action brought under federal rule 10b-5, § 33 of the Texas Securities Act, and § 27.01.

89. Bordwine, *supra* note 88, at 664. See also *Crofford v. Bowden*, 311 S.W.2d 954 (Tex. Civ. App.—Fort Worth 1958, writ ref'd) (art. 4004; fraud in a transaction involving stock); *Chandler v. Butler*, 284 S.W.2d 388 (Tex. Civ. App.—Texarkana 1955, no writ) (art. 4004; fraud in a transaction involving stock).

90. Bordwine, *supra* note 88, at 664. See also *Brooks v. Parr*, 507 S.W.2d 818 (Tex. Civ. App.—Amarillo 1974, no writ) (common law fraud action).

91. 1919 Tex. Gen. Laws ch. 43, § 1, at 77 (Tex. Rev. Civ. Stat. Ann. art. 4004 (Vernon 1966)) (repealed 1967).

92. See, e.g., *H.W. Broadus Co. v. Binkley*, 126 Tex. 374, 88 S.W.2d 1040 (1936) (art. 4004; fraud in a transaction involving real estate). Additional problems arose with respect to the phrasing of the inducement requirement of art. 4004. For example, use of the term "material" with respect to both the inducement requirement and the character of the misrepresentation led to confusion. See *Connor v. Buckley*, 380 S.W.2d 722 (Tex. Civ. App.—Waco 1964, no writ) (art. 4004; fraud in a transaction involving real estate). The term "material" was omitted with respect to inducement when the statute was codified as § 27.01.

93. 173 Tex. 271, 267 S.W.2d 544 (1954) (art. 4004; fraud in a transaction involving real estate).

94. *Id.* at 546 (quoting *Williamson v. Patterson*, 106 S.W.2d 753, 756 (Tex. Civ. App.—Eastland 1937, writ dismissed)).

95. TEX. BUS. & COM. CODE ANN. § 27.01(a)(1)(A), (2)(C) (Vernon 1968).

that are not connected with a prospectus or other selling document probably would not generate liability under the statute unless the plaintiff could demonstrate that their purpose was to induce a contract.

E. *Scienter*

Scienter refers to the underlying intent of the representor to deceive or mislead. At common law, scienter is present when the representor either knows that his representation is false or makes the representation recklessly without any knowledge of its truth and as a positive assertion.⁹⁶ Section 27.01, in two separate contexts, expressly requires that a particular representation be made with scienter. First, if the representation of a defendant was a promise to do an act, then the plaintiff must prove that the defendant made the promise with the present intention of not fulfilling it.⁹⁷ The scienter requirement, in this context, effectively limits the action on a promise to those situations where the injury arose from an actual intent to deceive rather than a mere failure to perform a promise. Secondly, persons who willfully make false representations or promises, or knowingly benefit therefrom, are liable for exemplary damages.⁹⁸

Scienter is conspicuously absent from the requisites of an action for misrepresentation of a fact under the statute. In light of the existence of the requirement in the two instances noted above, this omission is a significant indication of legislative intent.⁹⁹ Indeed, it probably occurred as the result of the statute's basis in the common law fraud action of the early 1900's. Although conflict existed among courts concerning whether scienter must be present for actionable fraud under the common law of Texas,¹⁰⁰ a long line of Texas cases consistently held that a party was liable for his misrepresentations even though innocently made.¹⁰¹ It appears that the legislature adopted this approach, extending it to transactions in stock.¹⁰²

Despite the failure of the statute to stipulate a scienter requirement, confusion has occurred in the courts regarding the existence of such a require-

96. *Stone v. Lawyers Title Ins. Corp.*, 554 S.W.2d 183, 185 (Tex. 1977); *Custom Leasing, Inc. v. Texas Bank & Trust Co.*, 516 S.W.2d 138, 143 (Tex. 1974); *Oilwell Div., United States Steel Corp. v. Fryer*, 493 S.W.2d 487, 491 (Tex. 1973); *Wilson v. Jones*, 45 S.W.2d 572, 573 (Tex. Comm'n App. 1932, holding approved).

97. TEX. BUS. & COM. CODE ANN. § 27.01(a)(2)(B) (Vernon 1968).

98. *Id.* § 27.01(c).

99. Keeton, *Rights of Disappointed Purchasers*, 32 TEXAS L. REV. 1, 13 n.37 (1953).

100. See generally Miller, *supra* note 50. Compare *Wilson v. Jones*, 45 S.W.2d 572 (Tex. Comm'n App. 1932, holding approved), *Avery Co. v. Harrison*, 267 S.W. 254 (Tex. Comm'n App. 1924, judgment adopted), and *Wimple v. Patterson*, 117 S.W. 1034 (Tex. Civ. App. 1909, no writ), with cases cited note 101 *infra*.

101. See, e.g., *Buchanan v. Burnett*, 102 Tex. 492, 119 S.W. 1141 (1909); *Mitchell v. Zimmerman*, 4 Tex. 75 (1849); *Booth v. Coward*, 265 S.W. 1026 (Tex. Comm'n App. 1924, judgment adopted); *Spencer v. Womack*, 274 S.W. 175 (Tex. Civ. App.—El Paso 1925, no writ); *Ford v. Sims*, 190 S.W. 1165 (Tex. Civ. App.—San Antonio 1917, no writ); *Benton v. Kuykendall*, 160 S.W. 438 (Tex. Civ. App.—Dallas 1913, writ ref'd); *Wells v. Driskell*, 149 S.W. 205 (Tex. Civ. App.—Austin 1912, no writ); *Gibbens v. Bourland*, 145 S.W. 274 (Tex. Civ. App.—San Antonio 1912, no writ).

102. See *Rick v. Farrell*, 266 S.W. 522, 527 (Tex. Civ. App.—Dallas 1924, no writ) (art. 4004; fraud in a transaction involving stock); Miller, *supra* note 50, at 154-55.

ment.¹⁰³ In *Crofford v. Bowden*¹⁰⁴ the court stated that "[t]o constitute actionable fraud as defined in the statute . . . it must appear that a material representation was made and that it was false; that when the party made it, he knew it was false, or made it recklessly without any knowledge of its truth, and as a positive fact."¹⁰⁵ This court ignored the clear import of the statute. Section 27.01 operates to incorporate into a contract factual representations of a party seeking to induce the other to enter into the contract. Liability is predicated on the existence of a misrepresentation, not scienter or wrongful intent. Section 27.01 is an extension of warranty theory to transactions in stock.¹⁰⁶ One court, recognizing that scienter was not a prerequisite to liability under the statute, explained:

[A]n unqualified statement that a fact exists, made for the purpose of inducing another to act upon it, implies that the one who makes it knows it to be true and speaks from such knowledge, if the facts represented do not exist, and the person states of his own knowledge that they do, and induces another to act upon his statement, the law imputes to him a fraudulent purpose.¹⁰⁷

Other courts have held that "intent to deceive"¹⁰⁸ and "knowledge of falsity"¹⁰⁹ of the representation are not required and that "good faith is no excuse."¹¹⁰

The divergence in the courts regarding the scienter requirement probably has arisen for several reasons. First, actions for misrepresentation of a fact have been confused with actions on a false promise.¹¹¹ In an action on a false promise the defrauded party has the burden of showing that the promise was made with the present intention of not fulfilling it.¹¹² Care-

103. Keeton, *supra* note 99.

104. 311 S.W.2d 954 (Tex. Civ. App.—Fort Worth 1958, writ ref'd) (art. 4004; fraud in a transaction involving stock).

105. *Id.* at 956. It is interesting to note that two of the cases cited by the court as authority on this point held that scienter was not an element of actionable fraud. See *Stroud v. Pechacek*, 120 S.W.2d 626, 629 (Tex. Civ. App.—Austin 1938, no writ); *Spencer v. Womak*, 274 S.W. 175, 176 (Tex. Civ. App.—El Paso 1925, no writ).

106. See Keeton, *supra* note 99, at 13; Miller, *supra* note 50, at 154-55. Dean Prosser has also recognized that the statute is an extension of warranty theory to representations made in transactions involving stock and real estate. See W. PROSSER, *supra* note 60, § 107, at 712 n.92 (citing *Speer v. Pool*, 210 S.W.2d 423 (Tex. Civ. App.—El Paso 1948, no writ), a case applying art. 4004 to fraud in the sale of real estate).

107. *White v. Bond*, 355 S.W.2d 225, 229 (Tex. Civ. App.—Amarillo), *rev'd on other grounds*, 362 S.W.2d 295 (Tex. 1962) (art. 4004; fraud in a transaction involving stock) (quoting *United States Gypsum Co. v. Shields*, 106 S.W. 724, 727 (Tex. Civ. App. 1907), *aff'd*, 101 Tex. 473, 108 S.W. 1165 (1908)).

108. *Vredenburgh v. Bachman*, 11 F.2d 473 (5th Cir. 1926) (art. 4004; fraud in a transaction involving real estate).

109. *Passero v. Loew*, 259 S.W.2d 909, 914 (Tex. Civ. App.—El Paso 1953, writ ref'd n.r.e.) (art. 4004; fraud in a transaction involving real estate).

110. *Roark v. Prideaux*, 284 S.W. 624, 628 (Tex. Civ. App.—Fort Worth 1926), *aff'd*, 291 S.W. 868 (Tex. Comm'n App. 1927, judgment adopted) (art. 4004; fraud in a transaction involving stock).

111. An early commentator on the scienter requirement at common law in Texas observed that the leading cases requiring scienter had mistakenly relied on cases in which the false representation was a promise rather than a fact. Miller, *supra* note 50, at 159. It appears that the same confusion has resulted in cases construing § 27.01.

112. TEX. BUS. & COM. CODE ANN. § 27.01(a)(2)(B) (Vernon 1968).

less language has been used by some courts in applying this rule. For example, in *Brooks v. Parr*¹¹³ the court explained that "a stock salesman's representations in the form of opinions or promises concerning future returns on the stock can amount to actionable fraud if the plaintiff proves that the representations were known to be false by the salesman making them when they were made."¹¹⁴ Although the court was clear on the requisites of actionable fraud and meant to refer only to actions on promises,¹¹⁵ the language used has led other courts to believe that the *Brooks* court required an intent to deceive for all types of misrepresentations.¹¹⁶

A second reason for the divergence of opinion concerning the requirement of scienter under section 27.01 for misrepresentation of a fact is that the scienter requirement has been a point of continuous confusion under the common law fraud action.¹¹⁷ It is interesting to note, however, that a line of recent Texas Supreme Court decisions appears to have settled the controversy under the common law in favor of the requirement.¹¹⁸ In *Stone v. Lawyers Title Insurance Corp.*¹¹⁹ the court stated that one element of a fraudulent representation is satisfied if "when the speaker made it he knew it was false or made it recklessly without any knowledge of the truth and as a positive assertion."¹²⁰ The court merely adopted the elements set out by the old Texas Commission of Appeals in *Wilson v. Texas*.¹²¹ The *Wilson* court, however, distinguished between misrepresentation of a fact and misrepresentation of an opinion, requiring scienter only in the latter situation.¹²² The supreme court failed to recognize this distinction, effec-

113. 507 S.W.2d 818 (Tex. Civ. App.—Amarillo 1974, no writ) (common law fraud action).

114. *Id.* at 820.

115. The court recognized that

[t]o be fraudulent, the misrepresentation must be one of present or past facts.

Before a promise to do something in the future can be actionable fraud, plaintiff must additionally plead and prove that at the very time such promise was made, the promisor did not intend to carry it out.

Id. at 819-20.

116. One court stated that "it appears some Texas cases require proof of scienter to establish actionable fraud. See, e.g., *Brooks v. Parr*, 507 S.W.2d 818, 820 (Tex. Civ. App. 1974)." *Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402, 408 (5th Cir. 1975).

117. See note 100 *supra*.

118. See *Stone v. Lawyers Title Ins. Corp.*, 554 S.W.2d 183 (Tex. 1977); *Custom Leasing, Inc. v. Texas Bank & Trust Co.*, 516 S.W.2d 138 (Tex. 1974); *Oilwell Div., United States Steel Corp. v. Fryer*, 493 S.W.2d 487 (Tex. 1973).

119. 554 S.W.2d 183 (Tex. 1977).

120. *Id.* at 185.

121. 45 S.W.2d 572, 573 (Tex. Comm'n App. 1932, holding approved).

122. The court explained that:

an expert's opinion as to a matter susceptible of knowledge is regarded as a statement of fact, upon which reliance may properly be placed, and, if it is made scienter . . . constitutes remediable fraud. . . . The rule is further well established in this state that, where affirmative representations of fact are made and designed to be acted upon by another and he does so believing them to be true when they are false, one making the representations is liable, regardless of his knowledge of falsity or intent to deceive.

Id. at 575 (citations omitted); see *Dittberner v. Bell*, 558 S.W.2d 527, 533 n.2 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.). The *Wilson* court merely took notice of the general

tively adopting a scienter requirement for all common law fraud actions.¹²³ Since the legislative mandate prohibits application of the *Stone* decision to section 27.01 actions, the statute now appears to provide a broader cause of action than that available under the common law.¹²⁴

F. Reliance

The reliance requirement ensures a causal connection between the misrepresentation and the injury.¹²⁵ In contrast with inducement, which requires an intent by the representor to influence the actions of the defrauded party, the reliance requirement focuses on the representation's actual effect on the defrauded party. In order to recover under section 27.01, the defrauded party must demonstrate that he relied on the false representation in entering into a contract.¹²⁶ Under common law, Texas courts require the plaintiff to show that but for the representation, he would not have entered into the contract.¹²⁷ Thus, section 27.01 merely adopted the common law rule requiring that the representation affect the defrauded party's course of conduct by causing him to enter into a contract that he would not have entered into had the representation not been made.

If it appears that the plaintiff was suspicious of the truth of the representation or that he knew that it was false, the representation cannot be regarded as a cause of his conduct or the resulting injury.¹²⁸ In this context, the relative knowledge of the parties on the subject matter of the represen-

rule that an opinion by its very nature is only an assertion of the representor's belief on which a party has no right to rely.

123. 554 S.W.2d at 185. Even in light of the apparent adoption of a scienter requirement by the Texas Supreme Court, confusion still exists. Compare *Dittberner v. Bell*, 558 S.W.2d 527, 533 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.), with *Fredonia Broadcasting Corp. v. RCA Corp.*, 569 F.2d 251 (5th Cir. 1978).

124. It is interesting to note that the statute also appears to allow a broader cause of action with respect to the culpability of the representor than that of § 33 of the Texas Securities Act. Under § 33, the seller of a security by means of an untrue statement or omission of a material fact and the person who buys or offers to buy by means of an untrue statement or omission of a material fact may avoid liability by proving that he could not have known of the misstatement or omission through the exercise of reasonable care. TEX. REV. CIV. STAT. ANN. art. 581—33(A)(2) & (B) (Vernon Supp. 1978-1979). Section 27.01 allows no such defense and does not require the plaintiff to demonstrate that the defendant was negligent. Section 27.01 allows the plaintiff to recover for purely innocent representations.

125. W. PROSSER, *supra* note 60, § 108, at 714.

126. TEX. BUS. & COM. CODE ANN. § 27.01(a)(1)(B) (Vernon 1968).

127. See *H.W. Broaddus Co. v. Binkley*, 126 Tex. 377, 88 S.W.2d 1040 (1936); *Buchanan v. Burnett*, 102 Tex. 495, 119 S.W. 1141 (1909); *Schmaltz v. Walder*, 566 S.W.2d 81 (Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e.); *Neuhaus v. Kain*, 557 S.W.2d 125 (Tex. Civ. App.—Corpus Christi 1977, writ ref'd n.r.e.); *First State Bank v. Olde Colony House*, 414 S.W.2d 221 (Tex. Civ. App.—Waco 1967, writ ref'd n.r.e.).

One alternative approach would find reliance on the misrepresentation when it acted as a material inducement to the contract. It would not require that the representation be "paramount, or the decisive, inducement which tipped the scales, so long as it plays a substantial part in affecting the plaintiff's decision." W. PROSSER, *supra* note 60, § 108, at 715. See also *Hester v. Shuster*, 234 S.W. 713, 716 (Tex. Civ. App.—San Antonio 1921, writ dis'm'd). The Texas Supreme Court rejected this approach in *H.W. Broaddus Co. v. Binkley*, 126 Tex. 374, 378, 88 S.W.2d 1040, 1042 (1936), stating that it was necessary to determine whether the contract would have been signed without the representations having been made.

128. W. PROSSER, *supra* note 60, § 108, at 714.

tation as well as the conduct of the plaintiff will usually be determinative. Consequently, if the representation is such that both parties are equally cognizant of its truth, there is no actionable fraud.¹²⁹ Further, if a purchaser makes his own free and unhampered investigation with regard to the subject of the false representations and obtains the information that he desires, then he is presumed to have relied on his own investigation rather than the misrepresentation.¹³⁰

Under the common law fraud action, it is not enough that the defrauded party show that the misrepresentation actually caused him to enter into a contract. In addition, he must demonstrate that he had the "right to rely" on the representation of defendant.¹³¹ The general rule is that a party has the right to rely on factual representations that are not utterly unreasonable.¹³² Applying these principles in an action under section 27.01, one court held that a purchaser of stock was "justified" in relying on representations concerning the value of stock made by the president of the company that issued the stock.¹³³ Similarly, under both common law and section 27.01, a defrauded party's cause of action is not precluded even though he could have discovered the fraud through a diligent investigation.¹³⁴ Thus, it appears that the defrauded party is under no duty to investigate the truthfulness of the defendant's representations.

G. *Persons Liable*

Section 27.01 provides that both "a person who makes a false representation or false promise, and a person who benefits from that false representation or false promise" are liable for actual damages to the person defrauded.¹³⁵ In addition, the statute provides that both the person willfully making the false representation and any person who knowingly bene-

129. *Seideman v. Callahan*, 34 S.W.2d 406, 407 (Tex. Civ. App.—San Antonio 1930, writ *dism'd*) (art. 4004; fraud in a transaction involving real estate).

130. *Lone Star Mach. Corp. v. Frankel*, 564 S.W.2d 135, 138 (Tex. Civ. App.—Beaumont 1978, no writ) (§ 27.01; fraud in a transaction involving real estate); *M.L. Mayfield Petroleum Corp. v. Kelly*, 450 S.W.2d 104, 110 (Tex. Civ. App.—Tyler 1970, writ *ref'd n.r.e.*) (§ 27.01; fraud in a transaction involving real estate).

131. *See Russell v. Industrial Transp. Co.*, 113 Tex. 441, 251 S.W. 1034 (1923); *Lewis v. River Oaks Capital Corp.*, 466 S.W.2d 348 (Tex. Civ. App.—Houston [1st Dist.] 1971, writ *ref'd n.r.e.*); *Oneal v. Weisman*, 88 S.W. 290 (Tex. Civ. App. 1905, no writ).

132. *Guitar Trust Estate v. Boyd*, 120 S.W.2d 914, 918 (Tex. Civ. App.—Eastland 1938, no writ). It appears that "[t]he plaintiff's conduct must not be so utterly unreasonable, in the light of the information open to him, that the law may properly say that his loss is his own responsibility." *W. PROSSER, supra* note 60, § 108, at 715. The defrauded party is not required to demonstrate that a reasonable man would have been justified in relying on the false representations. *Bell v. Henson*, 74 S.W.2d 455, 457 (Tex. Civ. App.—Waco 1934, writ *dism'd*).

133. *Crofford v. Bowden*, 311 S.W.2d 954 (Tex. Civ. App.—Fort Worth 1958, writ *ref'd*) (art. 4004; fraud in a transaction involving stock).

134. *Id.* at 956, applying this approach to an action for fraud in a transaction involving stock under art. 4004. For common law cases, see *Buchanan v. Burnett*, 102 Tex. 492, 119 S.W.1141 (1909); *Labbe v. Corbett*, 69 Tex. 503, 6 S.W. 808 (1888); *Bush v. Stone*, 500 S.W.2d 885 (Tex. Civ. App.—Corpus Christi 1973, writ *ref'd n.r.e.*); *Trinity-Universal Ins. Co. v. Maxwell*, 101 S.W.2d 606 (Tex. Civ. App.—Austin 1937, writ *dism'd*).

135. TEX. BUS. & COM. CODE ANN. § 27.01(b) (Vernon 1968).

fits from it are liable for exemplary damages.¹³⁶ The portion of the statute imposing liability on a party for benefitting from the misrepresentation was quick to receive criticism. In *Ulrich v. Krueger*¹³⁷ the court stated that it "would hold invalid and void that provision of the act which apparently makes one merely deriving benefit from the fraud practiced by others liable not only for all the actual damages suffered, but also for exemplary damages as well—an unreasonable and discriminatory requirement we think."¹³⁸ The provision, nevertheless, survived the scrutiny of the United States Supreme Court in *James-Dickinson Farm Mortgage Co. v. Harry*.¹³⁹ The Court rejected the contention that the imposition of liability regardless of the defendant's participation in the fraud violated the due process clause of the Constitution.¹⁴⁰ The Court noted that the statute imposed no more liability for innocent conduct than the common law or other constitutional statutes. It stated that "[a]t common law every member of a partnership is subject to such a liability . . . and often stockholders of corporations are made similarly liable by statute."¹⁴¹

The statute imposes joint and several liability on both the party who makes the representation and also the party who benefits therefrom.¹⁴² Privity is not required. Thus, the president of a corporation who made willful misrepresentations to induce plaintiffs to enter into a contract with the corporation was held liable to plaintiffs individually even though there was no contractual relationship between the plaintiffs and the president.¹⁴³

At the time the statute was enacted the common law rule was that a principal was liable for the false representations of his agent if they were either authorized by the principal or made in the scope of the agent's employment.¹⁴⁴ Further, Texas courts held the principal liable even though he did not authorize nor was aware of the false representations, if the principal received the "benefit" of the fraudulent acts.¹⁴⁵ The apparent basis for liability was that acceptance of the benefit constituted a ratification of

136. *Id.* § 27.01(c).

137. 272 S.W. 824 (Tex. Civ. App.—Galveston 1924, no writ) (art. 4004; fraud in a transaction involving stock). *See also* *Wise v. Anderson*, 163 Tex. 608, 615, 359 S.W.2d 876, 881 (1962) (art. 4004; fraud in a transaction involving real estate); *Smith v. Jordan*, 220 S.W.2d 481, 486 (Tex. Civ. App.—Dallas 1949, no writ) (art. 4004; fraud in a transaction involving real estate); *Krueger v. Waugh*, 261 S.W. 196, 197 (Tex. Civ. App.—Galveston 1924, writ dismissed) (art. 4004; fraud in a transaction involving stock).

138. 272 S.W. at 825.

139. 273 U.S. 119 (1927) (art. 4004; fraud in a transaction involving real estate).

140. *Id.* at 122-25.

141. *Id.* at 123 (citations omitted).

142. TEX. BUS. & COM. CODE ANN. § 27.01(b), (c) (Vernon 1968). *See also* *McCarty v. Runkle*, 285 F.2d 144 (5th Cir. 1960) (art. 4004; fraud in a transaction involving stock).

143. *See* *R.O. McDonnell Dev. Co. v. Schlueter*, 339 S.W.2d 701 (Tex. Civ. App.—Fort Worth 1960, writ refused n.r.e.) (art. 4004; fraud in a transaction involving real estate).

144. *Barber v. Keeling*, 204 S.W. 139, 140 (Tex. Civ. App.—San Antonio 1918, no writ); *Foix v. Moeller*, 159 S.W. 1048, 1052 (Tex. Civ. App.—El Paso 1913, writ refused).

145. *American Nat'l Bank v. Cruger*, 91 Tex. 446, 44 S.W. 272 (1898); *Delaware Punch Co. v. Reinartz*, 61 S.W.2d 135 (Tex. Civ. App.—San Antonio 1933, writ refused); *Barber v. Keeling*, 204 S.W. 139 (Tex. Civ. App.—San Antonio 1918, no writ); *Foix v. Moeller*, 159 S.W. 1048 (Tex. Civ. App.—El Paso 1913, writ refused).

the agent's acts giving rise to liability.¹⁴⁶ The predecessor of section 27.01 codified this ratification approach by extending liability to all persons deriving the benefit of the fraud. It was intended, however, as an independent ground of recovery and not as a replacement for the common law rule that a principal is liable for fraudulent acts of his agent within the scope of his authority.¹⁴⁷ The principal, therefore, may be held liable for actual damages under the statute even though he received no benefit from the fraudulent acts of his agent.

The statute applies to transactions "involving" stock, and therefore is not limited to representations made by the seller. Rather, it prohibits fraudulent representations made by both purchasers and sellers of stock. Consequently, in *Chandler v. Butler*¹⁴⁸ a purchaser of stock who, for the purpose of inducing a sale, made false representations to the owner regarding the value of the stock was held liable under the statute.

The decision of the Texas Supreme Court in *American Title Insurance Co. v. Byrd*¹⁴⁹ may have a significant impact on the types of parties subject to liability under the statute. Pursuant to an escrow agreement concerning the sale of a tract of real estate, the title company issued a title insurance policy to the purchaser of real estate at the expense of the seller. The policy omitted a reference to two outstanding undivided mineral interests held by third parties. The purchasers brought suit against the title insurance company under the statute to recover the difference between the value of the real estate as represented and the value reduced by the outstanding mineral interests. The Texas Supreme Court held that the statute was inapplicable to the title insurance transaction because it was not a transaction in real estate or stock and was only incidental to plaintiffs' purchase of real estate.¹⁵⁰ The court discerned a legislative intent to limit the scope of the statute in its emergency clause.¹⁵¹ Furthermore, the court stated that the statute is penal in nature and, therefore, should be strictly construed.¹⁵² The decision indicates that courts may be hesitant to impose liability under section 27.01 on parties not directly involved in a purchase or sale transaction. In particular, the decision may sound the death knell on establishment of liability against all but buyers, sellers, and active inducers with an economic stake in the transaction.

146. *American Nat'l Bank v. Cruger*, 91 Tex. 446, 451, 44 S.W. 278, 280 (1898); *Barber v. Keeling*, 204 S.W. 139, 141 (Tex. Civ. App.—San Antonio 1918, no writ); *Foix v. Moeller*, 159 S.W. 1048, 1053 (Tex. Civ. App.—El Paso 1913, writ ref'd).

147. *Boyd v. Eikenberry*, 99 S.W.2d 701, 703 (Tex. Civ. App.—San Antonio 1936), *rev'd on other grounds*, 132 Tex. 408, 122 S.W.2d 1045 (Tex. 1939) (art. 4004; fraud in a transaction involving real estate).

148. 284 S.W.2d 388 (Tex. Civ. App.—Texarkana 1955, no writ) (art. 4004; fraud in a transaction involving stock).

149. 384 S.W.2d 683 (Tex. 1964) (art. 4004; fraud in a transaction involving real estate).

150. *Id.* at 685.

151. *Id.* For text of emergency clause of statute, see note 47 *supra*.

152. *Id.* at 686.

H. *Damages*

As previously noted, section 27.01 was intended to modify the common law measure of damages in fraud actions.¹⁵³ The statute defines "actual damages" as the "difference between the value of . . . stock as represented or promised, and its actual value in the condition in which it is delivered at the time of the contract."¹⁵⁴ The statute, therefore, allows the successful plaintiff to recover the benefit of his bargain. In addition, the statute allows recovery of "exemplary damages not to exceed twice the amount of actual damages" from a person who willfully makes a false representation or knowingly benefits therefrom.¹⁵⁵ Thus, a defrauded party who was the subject of a willful misrepresentation may recover an amount equivalent to three times the benefit-of-bargain measure of damages.

To recover the statutory measure the plaintiff is required to provide proof establishing the value of the stock received and the value of the stock as represented.¹⁵⁶ The decision of the Texas Supreme Court in *White v. Bond*¹⁵⁷ illustrates the severe consequences of failing to introduce evidence sufficient to establish the value of the stock as represented. The purchasers of stock in an uranium mining company brought suit against the sellers who made representations that at some time in the future the stock would sell "at ten cents per share" and that the purchasers could get "three or four cents per share" at any time.¹⁵⁸ The court held that these statements were insufficient to establish the value of the stock as represented, reasoning that the representations were too vague and indefinite to form a basis for proof of the value of the stock.¹⁵⁹ Plaintiffs, therefore, were precluded from recovering damages under the statute. It is interesting to note that the court did not allow the purchasers to recover even the purchase price of the stock, apparently because the purchasers failed to allege that the price paid was evidence of the value of the stock as represented. Purchase price, however, has been held to constitute evidence of the value as represented when there was careful negotiation based on the false representations.¹⁶⁰

The statutory measure is not exclusive and does not supersede the common law measure.¹⁶¹ Accordingly, if the defrauded party has a large

153. See notes 58-60 *supra* and accompanying text.

154. TEX. BUS. & COM. CODE ANN. § 27.01(b) (Vernon 1968).

155. *Id.* § 27.01(c). "Willfully" has been defined as meaning "knowingly, intentionally, deliberately, or designedly." *J.S. Curtiss & Co. v. White*, 90 S.W.2d 1095, 1100 (Tex. Civ. App.—El Paso 1935, writ dism'd by agr.) (art. 4004; fraud in a transaction involving stock).

156. See *Bryant v. Vaughn*, 33 S.W.2d 729, 730 (Tex. 1930) (art. 4004; fraud in a transaction involving real estate).

157. 362 S.W.2d 295 (Tex. 1962) (art. 4004; fraud in a transaction involving stock).

158. *Id.* at 297.

159. *Id.*

160. *English v. Ramo, Inc.*, 474 S.W.2d 600, 608 (Tex. Civ. App.—Dallas 1971), *rev'd and modified on other grounds*, 500 S.W.2d 461 (Tex. 1973).

161. See *Hughes v. Halliday*, 471 S.W.2d 88, 90 (Tex. Civ. App.—Waco 1971, no writ) (§ 27.01; fraud in a transaction involving real estate); *El Paso Dev. Co. v. Ravel*, 339 S.W.2d 360, 364 (Tex. Civ. App.—El Paso 1960, writ ref'd n.r.e.) (art. 4004; fraud in a transaction involving real estate). See also *Collins v. Miller*, 443 S.W.2d 298 (Tex. Civ. App.—Austin

amount of special damages, he is not limited to the amount determined under the statute.¹⁶² Rather, he can recover his special damages by bringing suit under the common law action.¹⁶³

I. Other Considerations

Scope. Section 27.01 is limited to transactions involving stock¹⁶⁴ in a corporation or joint stock company.¹⁶⁵ Although the majority of cases brought under the statute concern purchases or sales of stock, a few cases are instructive as to what types of transactions fall within the scope of the statute. One of the earliest cases addressing this point was *Ulrich v. Krueger*.¹⁶⁶ In *Ulrich* the court took a literal approach to application of the statute and held that the statute did not apply to the purchase of the entire business and property of a corporation¹⁶⁷ because there was no mention of stock or shares in the sales agreement.¹⁶⁸

In *Thompson v. American Power and Light Co.*¹⁶⁹ the Court of Appeals for the Fifth Circuit refused to apply the statute to a transaction ostensibly involving the purchase of stock. Plaintiffs purchased both corporate stock and a promissory note of Texas Public Utilities Company in the principal sum of \$2,200,000 with \$600,000 accrued interest. They later brought suit under the statute alleging that the balance sheet of the company understated the loss from past operations and failed to disclose that the property

1969, writ ref'd n.r.e.) (art. 4004; fraud in a transaction involving real estate); Carruth v. Allen, 368 S.W.2d 672 (Tex. Civ. App.—Austin 1963, no writ) (art. 4004; fraud in a transaction involving real estate).

162. El Paso Dev. Co. v. Ravel, 339 S.W.2d 360, 365 (Tex. Civ. App.—El Paso 1960, writ ref'd n.r.e.) (art. 4004; fraud in a transaction involving real estate).

163. See Collins v. Miller, 443 S.W.2d 298, 301 (Tex. Civ. App.—Austin 1969, writ ref'd n.r.e.) (art. 4004; fraud in a transaction involving real estate); Carruth v. Allen, 368 S.W.2d 672, 680 (Tex. Civ. App.—Austin 1963, no writ) (art. 4004; fraud in a transaction involving real estate).

164. TEX. BUS. & COM. CODE ANN. § 27.01(a) (Vernon 1968). By its terms the statute is limited to transactions in "stock." Therefore, it must be presumed that it applies only to what has traditionally been known as stock: "a proportional part of certain rights in the management and profits of the corporation during its existence, and in the assets upon dissolution." Thayer v. Wathen, 44 S.W. 906, 909 (Tex. Civ. App. 1897, writ ref'd). For this reason, the statute does not encompass the more expansive concept of a "security." See TEX. REV. CIV. STAT. ANN. art. 581—4(A) (Vernon 1964).

165. A joint stock company is an unincorporated association created by agreement generally providing for centralized management and transferable shares. J. CRANE & A. BROMBERG, LAW OF PARTNERSHIP § 34, at 178 (1968). Although the Texas Supreme Court has characterized joint stock companies as a form of partnership, these organizations resemble corporations in most respects except that they do not provide limited liability to their shareholders. See Thompson v. Schmitt, 115 Tex. 53, 64-67, 274 S.W. 554, 558-59 (1925); J. CRANE & A. BROMBERG, *supra*, § 34, at 178. Further, joint stock companies are treated as corporations for federal income tax purposes. Burk-Wagoner Oil Ass'n v. Hopkins, 269 U.S. 110 (1925); I.R.C. § 7701(a)(3). For this reason and the absence of limited liability for the shareholders, joint stock companies are rarely used.

166. 272 S.W. 824 (Tex. Civ. App.—Galveston 1925, no writ) (art. 4004; fraud in a transaction involving stock).

167. *Id.* at 825.

168. *Id.*

169. 192 F.2d 651 (5th Cir.), *cert. denied*, 342 U.S. 954 (1951) (art. 4004; fraud in a transaction involving stock).

owned by the company had been fully depreciated for tax purposes. The court of appeals stated that the transaction was within neither the letter nor the spirit of the statute.¹⁷⁰ It reasoned that although the purchase involved stock, it was "in a completely subordinate and incidental way, the indebtedness represented by the note being in an amount so large as to deprive the stock of any substantial value, indeed to render it worthless."¹⁷¹ The court, therefore, refused to apply the statute to the transaction, finding that in substance it was a purchase of a note and not stock in a corporation. In a more recent decision the Texas Supreme Court refused to apply the statute to a title insurance transaction, reasoning that it was only incidental to the purchase of real estate.¹⁷² These decisions indicate that courts will be hesitant to extend the scope of the statute beyond a bona fide purchase or sale of stock.¹⁷³

Statute of Limitations. No specific statute of limitations was provided for in section 27.01. Article 5526(4) of the Texas Revised Civil Statutes, however, has been judicially construed to limit these actions.¹⁷⁴ Pursuant to article 5526(4) and common law principles, an action brought under section 27.01 is barred by the statute of limitations if it is filed more than two years after the defrauded party has acquired knowledge of facts that would cause a reasonably prudent person to make an inquiry leading to the discovery of fraud.¹⁷⁵ The question of what knowledge of facts will trigger the running of the statute is ordinarily a factual question. One court has held that the statute began to run on the date of availability of audited financial statements from which a reasonable purchaser could have obtained omitted facts.¹⁷⁶ Further, failure to deliver stock certificates on the date promised was held to put a reasonably prudent person on notice of the breach and fraud within "two or three months" of that date.¹⁷⁷

170. 192 F.2d at 653.

171. *Id.* at 654.

172. *American Title Ins. Co. v. Byrd*, 384 S.W.2d 683 (Tex. 1964) (art. 4004; fraud in the sale of real estate). For discussion, see notes 149-51 *supra* and accompanying text.

173. The Texas Supreme Court has characterized the statute as penal in nature and has found a legislative intent to limit its scope. *See American Title Ins. Co. v. Byrd*, 384 S.W.2d 683, 685-86 (Tex. 1964) (art. 4004; fraud in a transaction involving real estate); *Westcliff Co. v. Wall*, 153 Tex. 271, 274, 267 S.W.2d 544, 546 (1954) (art. 4004; fraud in a transaction involving real estate). It is reasonable, therefore, to conclude that the statute will be limited in its application to stock in corporations and joint stock companies. Presumably, the statute does not apply to interests in general and limited partnerships, or joint ventures. *See* note 165 *supra*.

174. *Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402, 407 (2d Cir. 1975); *Richardson v. Salinas*, 336 F. Supp. 997, 1000 (N.D. Tex. 1972). *See also White v. Bond*, 362 S.W.2d 295 (Tex. 1962) (art. 4004; fraud in a transaction involving stock).

175. *See White v. Bond*, 362 S.W.2d 295 (Tex. 1962) (art. 4004; fraud in a transaction involving stock); *Stone v. Enstam*, 541 S.W.2d 473 (Tex. Civ. App.—Dallas 1976, no writ) (§ 27.01; fraud in a transaction involving stock); *Ryan v. Collins*, 496 S.W.2d 205 (Tex. Civ. App.—Tyler 1973, writ ref'd n.r.e.) (§ 27.01; fraud in a transaction involving stock).

176. *Stone v. Enstam*, 541 S.W.2d 473, 479 (Tex. Civ. App.—Dallas 1976, no writ) (§ 27.01; fraud in a transaction involving stock).

177. *Ryan v. Collins*, 496 S.W.2d 205, 211 (Tex. Civ. App.—Tyler 1973, writ ref'd n.r.e.) (§ 27.01; fraud in a transaction involving stock).

Election of Remedies. A defrauded party in a stock transaction may bring an action under the common law, section 27.01, or section 33 of the Texas Securities Act.¹⁷⁸ The Texas Securities Act provides that its remedies are in addition to other rights of the plaintiff that exist at law or in equity.¹⁷⁹ The comment to the 1977 amendments to section 33 of the Texas Securities Act explains that "all common law and statutory liabilities outside the Texas Securities Act, including § 27.01 . . . , remain intact and may be used along with the Texas and U.S. Securities Act liabilities."¹⁸⁰ The remedy provided by section 27.01, therefore, may be utilized in conjunction with remedies available under both the Texas Securities Act and the common law.¹⁸¹

III. CONCLUSION

Section 27.01 possesses a unique combination of elements differing from both the common law fraud action and the statutory actions available under either SEC rule 10b-5 or section 33 of the Texas Securities Act. In this context, the most important feature of section 27.01 is the absence of a scienter requirement for actions founded on misrepresentation of a fact. Private plaintiffs unable to demonstrate some form of scienter are precluded by *Ernst & Ernst* from recovering under rule 10b-5. Recent decisions of the Texas Supreme Court indicate that the plaintiff bringing a common law fraud action must prove that the defendant made representations with knowledge that they were false or recklessly made without any knowledge of the truth and as a positive assertion. Finally, the defendant in a suit brought to recover damages or rescission under section 33 of the Texas Securities Act is liable only if he fails to show that he could not have known of the untruth or omission through the exercise of reasonable care. Section 27.01, however, does not predicate liability for actual damages on the presence of wrongful intent or negligence. Rather, section 27.01 permits recovery of actual damages for purely innocent representations.

In addition to the absence of a scienter or negligence requirement, the statute provides the successful plaintiff with a generous recovery. The defrauded party is allowed to recover the benefit of his bargain from a defendant making innocent misrepresentations, rather than the out-of-pocket measure normally applied in common law fraud actions. The benefit of treble damages is available when the false representation is shown to have been made willfully. This measure of damages should encourage defrauded investors to pursue their remedies under the statute.

One final advantage afforded the plaintiff proceeding under section 27.01 is worthy of mention. The statute's basis in common law fraud principles makes stating and litigating a cause of action a relatively simple

178. See generally Bordwine, *supra* note 88.

179. TEX. REV. CIV. STAT. ANN. art. 581—33(M) (Vernon Supp. 1978-1979).

180. *Id.* art. 581—33, comment.

181. See, e.g., *Chagas v. Berry*, 369 F.2d 637 (5th Cir. 1966), *cert. denied*, 389 U.S. 872 (1967).

matter. The plaintiff need only show that in a transaction involving stock a false representation was made to induce him to enter into a contract and that he relied on the false representation in entering into the contract.¹⁸² Thus, in light of the advantages afforded the plaintiff proceeding under section 27.01 and the trend toward reduction of remedies available in federal courts, defrauded investors should be encouraged to employ the remedies available under section 27.01.

182. Bordwine, *supra* note 88, at 670-71.

